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Whatever Happened To the European Recovery?

Europe's long-awaited economic recovery has been delayed yet again. Originally scheduled to arrive at the start of 1982, the upswing was subsequently rescheduled for mid-year. But by mid-year it became clear that, while inflation was falling, output was flat if not declining, and leading indicators were, at best, lackluster. What went wrong?

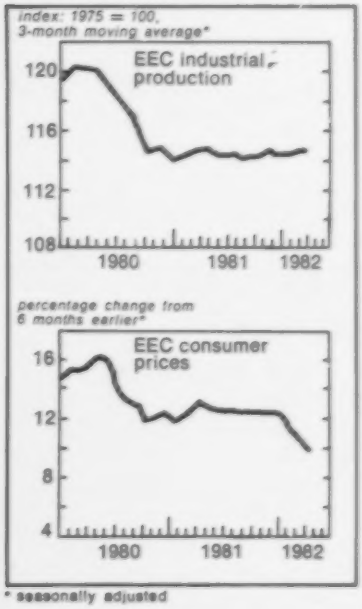
One part of the answer lies beyond Europe's shores. Recessions in the United States and Japan have proved longer and deeper than originally expected. At the same time, OPEC and the non-oil-producing developing countries, faced with falling revenues, have cut back imports.

The other part lies in the interplay of uncertainty, interest rates, and fiscal stance at home. Despite an outward appearance to the contrary, fiscal policy has been tightened in most European countries as governments have countered recession-induced rises in public-sector deficits by tightening spending and raising taxes. The view is that, in the longer run, lower deficits are necessary for a lower and more stable rate of monetary expansion—and lower interest rates. And this, in turn, is a precondition for stable, non-inflationary growth. In the short run, however, real demand was deflated but real interest rates failed to decline—partly because of financial-market doubts about the longevity of fiscal rectitude.

In addition, although Europe's monetary policies were eased somewhat in the first half of 1982, the uncertainty created by the recession and by the post-1979 instability in American interest rates led to an upward shift in the worldwide demand for liquidity, holding interest rates—in relation to inflation rates—well above their historical levels, depressing investment expenditures. That same uncertainty has also raised personal savings rates and therefore depressed consumption expenditures.

In short, policymakers' hopes that a marked fall in inflation rates would be sufficient to stimulate real growth so far have been frustrated. However, not all is bleak. Supply conditions are adjusting for non-inflationary growth: Falling real commodity prices are improving Europe's terms of international trade, inflation expectations are easing, and real wages in most countries are no longer rising faster than productivity. Furthermore, interest rates at last appear to be declining. The dilemma for Europe's policymakers is to judge whether lower inflation alone will be sufficient to raise real demand, or whether a boost to *nominal* demand—effective only if the above supply conditions are sufficiently advanced—will be necessary. The evidence to date suggests that policymakers believe the former, but early 1983 may well bring a change of heart.

European industrial output and inflation



* seasonally adjusted

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Canadian indicators point to GNP decline for 1982.

Soft spots in the Canadian economy are continuing to surface and official economic indicators offer little encouragement for the near-term outlook. Residential construction dropped sharply in the second quarter and business investment in plant and equipment also turned down—both partly the result of high interest rates. The investment decline, however, was also related to a deep erosion of corporate profits that has been evident since mid-1981. In this environment, the unemployment rate has jumped to a record level of 11.8% in July and seasonally-adjusted retail sales fell 4%. The export sector has shown larger surpluses this year but this is due more to declining imports than to export strength. There are expectations that export momentum will pick up toward the end of 1982, but this is contingent on an upturn in the U.S. and other world economies. A recent decline in Canadian interest rates could also provide a boost to investment later this year. The slowdown of economic activity that has already taken place, however, suggests a real GNP decline of about 2.5% for 1982.

French inflation eases—but for how long?

The price-control measures introduced by the French government in June, have produced a reduction in French inflation better than had been expected in official circles. The consumer price index is provisionally estimated to have increased by only 0.3% in July, following a rise of 0.7% in June. The increase in consumer prices over the past twelve months has now slipped to 11.9% and seems likely to fall below 11% by year-end. However, doubts remain as to whether this artificially induced slowdown will prove temporary or permanent. First, the government has yet to secure agreement on a voluntary incomes policy for when the wage-price controls are lifted at the end of October. Second, energy prices, which have been held down recently, are set to rise sharply when the freeze expires. Third, company profit margins have been severely squeezed over the summer months, raising the specter of some catch-up price increases at year-end. All in all, there is some danger that inflation may rebound to 13% next year when, elsewhere, inflation is expected to show a continued marked decline. Moreover, the current stance of French economic policy offers little hope of a significant and lasting reduction in French inflation.

Korea takes first steps toward liberalizing financial system.

The Korean government is following up its earlier economic stimulus program with reforms designed to liberalize the country's financial system. As of August 2, the government now permits individuals—although not corporations—to establish firms to make short-term loans. Previously, such financiers operated without official sanction. In addition, the government has announced the sale on September 9-10 of its controlling interest in two of Korea's banks. This will leave only one large commercial bank with substantial government ownership. In effect, however, the authorities will still retain control of savings and investment through interest-rate ceilings and lending quotas. Any significant opening up of the financial system will require steps toward eliminating these regulations.

Bangladesh adopts program of restraint in view of limits on economic aid.

The government of Bangladesh has announced a number of tough new economic measures in its budget for fiscal 1982-83, which began July 1. To reduce subsidies and increase the profitability of public-sector corporations, the government has instituted price increases amounting to 41% for petroleum products, 40% for electricity, and 14% for chemical fertilizers and has raised the prices for wheat and rice distributed through the ration system. New taxes on luxury goods and farmland will raise 1.3 billion taka, although some other taxes have been reduced or eliminated. In addition to these measures, the government took steps even before the budget was announced to slash development spending to T27 billion—the same level as last year and a figure much more realistic than the T33 billion originally planned, given the amount of aid currently available. For the longer term, prospects for any significant increase in foreign assistance are not at all favorable. Consequently, the government will have to mobilize substantially more resources domestically over the next several years to keep development spending from being severely constrained.

New Italian government raises taxes, cuts spending to trim public deficit.

Italy's two-week-old government crisis now seems set to resolve itself with the formation of a new government, again under Prime Minister Spadolini. This would save—at least for the time being—the austerity package agreed upon by the outgoing cabinet in response to the public sector's rapidly rising borrowing needs. Had policies remained unchanged, the public-sector borrowing requirement (PSBR) looked set to exceed this year's original target of 50 trillion lira by some 15-20 trillion lira and to show another sharp rise in 1983. The new measures include increases in gasoline taxes, higher rates of value-added tax, a 5-percentage-point rise in corporate-income-tax rates, and higher social security contributions by employers. These measures, which go into effect immediately but still require subsequent parliamentary approval, are expected to reduce the 1982 PSBR to 60 trillion lira. Envisaged spending cuts of up to 30 trillion lira and further tax increases would hold the 1983 PSBR to 63 trillion lira. These measures, if implemented, would reduce public sector borrowing from about 14% of GNP this year to about 12% next year.

Turkish trade deficit narrows; but inflation, other problems still confront policymakers.

Turkey's trade balance showed a further improvement in the first half of this year. The trade deficit narrowed to $1.7 billion in the first six months, compared with a gap of $2.3 billion for a comparable period in 1981. Exports rose by some 26% to $2.4 billion. At the same time, imports fell slightly to $4.1 billion, from $4.2 billion last year, mainly as a result of weaker prices for oil and dollar-denominated commodities. While real GDP growth is now expected to exceed 1981's official figure of 4.4%, all is not rosy. Turkey's financial system has recently experienced a series of major bankruptcies. In addition, both wholesale and consumer price inflation have started to rise again, the latter from a rate of just under 30% at the end of last year to some 36% by May. The country's new economic policymakers now face the difficult task of restoring confidence in the financial system while checking the rate of monetary expansion without aborting the recovery in real output.

Growth slowdown, worsening payments imbalance seen for Zimbabwe.

Contrary to expectations, Zimbabwe's real economic growth accelerated in 1981 to a rate of 12.9% from 11.7% in 1980, according to provisional figures. This was accompanied by only a moderate increase in the rate of inflation to 12.3%. Imports rose some 24%, while exports increased only marginally; consequently, the traditionally positive trade balance swung into an estimated $140 million deficit. Sharply higher deficits on investment income and transfer accounts also contributed to the widening of the current-account deficit, which rose to an estimated $175 million, from $290 million in 1980. Estimates place capital inflow—predominantly borrowings—at only $165 million, pointing to an overall payments deficit of $550 million for 1981. For 1982, economic growth is likely to be dampened substantially by drought-reduced maize and cotton crops and weak export demand. In the external sector, the anticipated slower rate of import growth may not fully offset the deteriorating export performance. However, for the overall balance of payments, aid inflows and lower investment income outflow could mitigate some of the effects of a worsened trade account.

Coffee harvest expected to fall sharply in coming year.

Thanks to a record harvest for the crop year just ending, the 1982/83 coffee season will begin in October with an unprecedented level of producer stocks at 44.7 million bags—nearly 50% of current world consumption requirements. With the relative price of coffee moving lower in the near term, consumption is anticipated to increase by 1 million bags to 84 million, despite the recent declining trend in per capita consumption. Output in the coming year, however, is expected to show a sharp turnaround from the past year. Latin American producers have already sustained major losses owing to frost and drought, and current forecasts project production will be down nearly 20% to 81 million bags. Currently, the International Coffee Organization's export quotas are being decreased in order to maintain prices near $1.40/lb.—the upper limit of the group's preferred range—and they are likely to remain high through January.

New Tax Act Reshapes Fiscal Policy

The large tax increase recently enacted in the United States clearly modifies—but does not reverse—previous trends in U.S. fiscal policy. Future federal deficits will be somewhat smaller than they would have been under prior law—and so will the incentives for business investment.

For most American individual and corporate taxpayers, the new law promises relatively minor changes over the next year or so. Receipts will be raised by an estimated $18 billion in fiscal year 1983, which begins this October 1. That represents an increase of only about 3%. The incremental boost to taxes, however, will double in fiscal 1984 and grow significantly in later years. But while this may reduce future deficits, it will not be sufficient to reverse their essentially upward trend.

Previous private estimates of the 1983 deficit had ranged as high as $180 billion, with the expectation that deficits would increase in succeeding years. The new tax law may generate enough revenue to hold those deficits in the neighborhood of $150-160 billion. Official estimates of future deficits are much smaller than this. But they assume faster economic growth than is anticipated by most private analysts and also reductions in spending that have yet to be legislated.

To the extent that huge future federal deficits threatened to keep interest rates high and to generate related difficulties in financing private economic activity, the outlook has been improved somewhat, but the problem has not been solved. Substantial economies will be required on the spending side of the federal budget before these major concerns of the money and capital markets are effectively eliminated.

The new law also significantly alters or offsets some of the provisions of the massive reduction in taxes that was enacted in 1981. The 1981 act had two major objectives: to reduce the overall burden of Federal taxation on the private economy and, in specific ways, to provide greater incentive to private saving and investment. When fully effective in the mid-1980s, the new law will offset about 20% of the reductions provided for in the 1981 act. But the distribution of this offset between individual and business taxpayers—and between the various incentives to saving and investment previously enacted—varies greatly.

As a general proposition, the burden of the new tax provisions falls more heavily on business than it does on individual taxpayers. This is true both in absolute terms and in terms of changes in the tax incentives enacted in 1981. By fiscal 1986, business will be providing well over half the increase in tax revenue provided for in the new act. And the proportion will

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1981		BALANCE				
		6 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	u cr lion
Argentina	New economic program attempts to revive industry through subsidized credit and export stimulus.	March	+ 8%	128.0	$4,547	April	2,806	−46%	3.1	
Brazil	Economy at low levels of activity while inflation rate moves upward.	April	−11%	284.8	2,307	June	5,835	+12%	3.2	
Chile	Government banks make $225 million available to construction, manufacturing, and agriculture.	June	− 4%	35.3	3,126	June	2,742	−16%	7.9	
Colombia	New monetary measures aimed at increasing liquidity and economic output.	April	+12%	37.3	1,399	June	4,301	− 7%	9.9	
Dominican Rep.	Tax revenues from exports and imports down sharply, result: large growth in fiscal deficit.	March	−13%	7.3	1,314	June	81	−57%	0.7	
Ecuador	New law permits services contracts for oil exploration by international companies.	April	−10%	13.4	1,634	June	571	−23%	3.3	
El Salvador	Estimate for 1981-82 coffee output set at 2.38 million bags—11% below previous year.	April	− 4%	3.3	666	June	89	+ 2%	1.2	
Guatemala	Tourism earnings for 1982 projected at $61 million—81% below last year.	March	−14%	9.0	1,239	June	142	−48%	1.2	
Haiti	IMF approves SDR 34.5 million standby program designed to reactivate economy, reduce fiscal deficit.	Feb.	− 2%	1.7	365	May	8	+11%	0.3	
Honduras	Economic activity continues to deteriorate with no improvement in sight for near future.	Nov.	− 2%	2.7	710	April	104	−17%	1.3	
Jamaica	Prospects favorable for further reduction in bauxite levy.	April	−28%	3.1	1,410	June	118	−20%	1.0	
Mexico	International financial support program being organized for external debt payments.	April	+ 4%	238.7	3,303	May	3,920	+15%	2.5	
Panama	International banking activity at high levels, but domestic economic conditions are slow.	March	−34%	3.8	2,027	April	94	− 8%	0.7	
Paraguay	Economic activity slowing because of delays in hydroelectric projects.	April	+ 7%	5.4	1,664	June	794	− 1%	13.6	
Peru	All government departments required to stick to 3-month cash budgets.	March	−17%	21.0	1,160	Dec.	1,209	−39%	3.7	
Puerto Rico	Slight modification in business taxation affecting Puerto Rico included in U.S. tax-increase.	May	−13%	11.7	3,658	June	10,928*	+ 6%	16.0	
Uruguay	Economic recession worsening; new tax and salary measures introduced to limit growing fiscal deficit.	Dec.	− 7%	10.9	3,711	July '81	403	− 5%	3.2	
Venezuela	Softer petroleum prices will mean continued economic stagnation.	Feb.	− 9%	69.4	4,454	June	6,528	−27%	6.8	

*Commercial Bank Deposits

grow rapidly in later years. Almost all businesses will be affected in some degree, although the burden of the new provisions will fall most heavily on those that make large capital investments.

Many individual taxpayers, by contrast, will feel little or no direct effect from the new law. Most of the increase in personal taxes will be paid by those who previously underpaid their taxes or who have significant amounts of income that will be subject to withholding tax for the first time. The withholding process will be extended to tips received by waiters and waitresses and to recipients of interest and dividend payments. In both cases, however, exemption from this provision will be available for many of those recipients.

The new law varies even more extremely in its treatment of the incentives to savings and investment enacted in 1981. For individuals, these incentives took two important forms. First, the top rate on the individual income tax was reduced to 50% from 70%, and a series of annual reductions in all tax bracket rates was adopted; the series was made perpetual by the adoption of indexing starting in 1985. These reductions are unaffected by the new law. Second, sizable reductions in taxes on earnings from savings and on estates and gifts were scheduled under the 1981 act. These, too, are untouched by the new law.

By contrast, much of the newly-enacted increase in business tax payments will come directly from changes in the investment incentives previously scheduled. This is true in only modest degree for the next two years. During that period, much of the increase in business taxes will come from a variety of changes in accounting rules, a rise in the tax paid to support the unemployment compensation system, and acceleration in corporate income tax payments. Most of the alterations in investment incentives, of which there are several, will individually produce relatively minor amounts of revenue during this period. (This does not mean that their effect on the companies directly involved will be minor. Repeal of "safe harbor" leasing as of 1984 will be extremely important for some.) In the mid-1980s, however, the emphasis of the new tax provisions shifts heavily to reduction of incentives for investment.

By fiscal 1987, the combination of changes in treatment of the Investment Tax Credit, the new rules on tax treatment of leasing, and—most important—repeal of the 1981 provision for accelerating depreciation in 1985 and 1986 will produce additional revenues of an estimated $31 billion. This is almost exactly half of all the additional revenue expected from all provisions of the new tax law in 1987. Repeal of the 1985-86 acceleration in depreciation will, by itself, account for more than half of the change in business tax revenues associated with investment by 1987.

Richard W. Everett

OF PAYMENTS		MONEY AND BANKING							COUNTRIES
e of IMF edit, mil- s of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars August 25, 1982	change from year earlier	current monetary conditions	
0	Multiple exchange system expands to 17 rates.	July	+137%	May	+132%	.000043	−83%	Deposit and loan rates regulated.	Argentina
0	Pace of mini-devaluations increasing.	July	+100%	April	+ 74%	.0060	−52%	Domestic interest rates remain at high levels.	Brazil
23	Currency currently trading in the vicinity of 55 pesos per dollar.	May	+ 4%	March	− 2%	.0174	−36%	Domestic credit being expanded.	Chile
0	Increase in government export credit lines.	June	+ 24%	April	+ 24%	.0160	−24%	Bank loans show large rise.	Colombia
60	Prospects for external accounts bleak in foreseeable future.	Jan.	+ 6%	April	+ 12%	Par	—	Credit to public sector rising.	Dominican Rep.
0	Oil export earnings decline because of price softness.	April	+ 12%	Jan.	+ 12%	.0174	−50%	Interest rates rise.	Ecuador
41	Parallel foreign exchange market to be established soon to halt black market.	April	+ 11%	April	+ 3%	.4032	0	Liquidity is tight.	El Salvador
104	June international reserves totalled $142 million, vs. $273 million year earlier.	April	+ 1%	March	− 1%	Par	—	Net foreign assets falling.	Guatemala
34	Government attempting to reduce payments arrears.	Dec.	+ 17%	Feb.	+ 15%	.2050	0	Domestic credit increased slightly.	Haiti
61	More stringent import controls and slower GDP growth will lower imports.	April	+ 10%	Feb.	+ 1%	.50018	0	Net foreign assets on the decline.	Honduras
492	Tourism improving; first quarter earnings 44% above year-earlier.	April	+ 7%	March	+ 13%	.5700	0	Credit growth contained as part of IMF agreement.	Jamaica
0	Three exchange rates set for currency.	May	+ 45%	March	+ 37%	.0095	−77%	Domestic liquidity highly limited.	Mexico
86	Re-exports to Latin America decline.	May	+ 4%	Dec.	+ 10%	Par	—	Local time-deposit rates increase.	Panama
0	Controls placed on foreign exchange sales.	Feb.	+ 6%	Feb.	− 4%	.0080	0	Monetary policy is restrictive.	Paraguay
322	Faster pace of mini-devaluation—about 5%-6% per month—will be maintained.	April	+ 61%	April	+ 46%	.0016	−36%	Credit policy is tight.	Peru
—	Imports decline during April-May.	June	+ 4%	June	+ 6%	Par	—	Loan growth slowing.	Puerto Rico
0	Reserves continue to fall; possible maxi-devaluation by year-end.	March	+ 22%	Feb.	0	.07781	−14%	Net foreign assets dropping.	Uruguay
0	Oil output at 2.1 million bpd—above OPEC ceiling set earlier this year.	May	+ 12%	March	+ 5%	.2300	− 1%	International reserves continue to fall.	Venezuela

World Interest Rates

market rates as of Aug. 25, 1982; bond yields as of Aug. 20, 1982

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.50	14.26	11.25 intervention rate	13.52	9.50	7.50	19.00 penalty rate 20.80	8.00	5.50	5.50
Day-to-Day Money	9.125 August 26	17.00	11.625	12.45	14.50	8.80	18.75	8.50	6.25 1-month Euro-Swiss fr. rate	7.125
Treasury Bills 91-day, Middle Rates	7.55	13.70	10.25	13.75	n. a.	n. a.	17.18 92 days	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	9.625 finance paper discount basis	14.00 finance paper 15% tax w/h	9.961	13.40 Certified	14.625 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	9.35	13.95 15% tax w/h	10.1875	13.40 Certified	not traded	9.40	21.00	no market	4.4375	no market
Government Bonds Long-term, new and old issues, average yield	12.15	14.50	11.46	10.161 20% tax w/h	15.17	8.98	19.88	10.07	4.75	8.521
Industrial Bonds prime, long-term, new and old issues, average yield	14.00 Aa Industrials	15.50	12.96	14.173	16.46	9.02	20.24	11.23	6.19	6.64
Bank Short-Term Rate to Best Borrowers (prime rate)	13.50	16.00	12.00	16.75	16.60	11.50	21.75 ½ qtrly fee on outstdng.	10.50	9.00	6.00
Bank Time Deposits 3-month	9.25 Cert. of Dep.	13.75	10.625	13.65	14.6875	8.45	11.50	8.50 large deposits	3.50 residents only	3.75
Eurocurrencies 3-month, asked	10.6875	14.50	10.8125	no market	22.00	8.1875	no market	8.4375	4.125	7.4375
Exchange Rates—in U.S.$ rates floating against the $	—	.8110	1.7560	.0214	.1460	.4108	.000726	.3745	.4866	.003956
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	3.75 *D*	0.125 *D*	3.00 *D*	13.50 *D*	2.50 *P*	9.75 *D*	2.50 *P*	6.50 *P*	3.125 *P*

Eurodollar Deposits
(London, interbank, bid)
August 26

7-day	9.4375
1-month	9.75
3-month	10.5625
6-month	11.6875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−2.434
U.S.-Canada Treasury Bills	−1.766
U.S.-Canada Finance Co. Paper	−0.433
Eurodollars-U.K. Local Auth. Deposits	+0.250

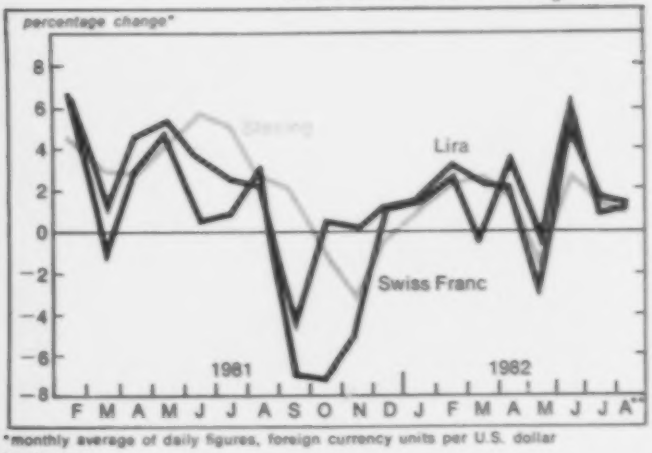
Eurobonds
(average yield on recent straight debt issues)

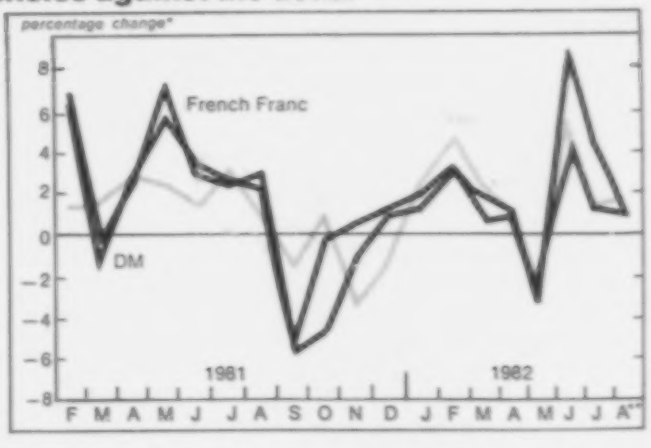
U.S. Dollar Bonds	
7 yrs. and under	13.75
Over 7 yrs.	14.25
DM Bonds	
7 yrs. and under	9.125
Over 7 yrs.	9.125

Gold Price
London afternoon fixing
401.00
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Movements of major currencies against the dollar





*monthly average of daily figures, foreign currency units per U.S. dollar

** estimates

Japan's Changing Financial Markets

Editor's Note: The Japanese financial system has undergone rapid structural change since the early 1970s. This is the first in a three-part series examining the evolution of the Japanese financial markets and the implications for monetary control and the behavior of the yen. This article discusses the operation of the postwar financial system through the 1960s --just prior to the period of dramatic change--focusing on how monetary, fiscal, and foreign exchange policies influenced its development. Subsequent articles will review and analyze changes in the system since the early 1970s and consider its probable evolution over the next several years.

The Japanese government has come under increasing pressures in recent months--both from foreign trading partners and from its own financial institutions--to accelerate the liberalization of the Japanese financial markets. Without letting up on demands that Japan restrain its exports and open its domestic markets to foreign products, the United States and Europe have stepped up their criticism of the supposedly closed nature of the Japanese financial markets. In addition, as Japanese budget deficits and the level of outstanding government debt have soared, Japan's financial institutions--the principal holders of government bonds in Japan--have become increasingly unwilling to buy new bonds at below-market rates.

These external and internal forces are compelling wide-ranging reforms of a system that has already undergone radical changes. Until relatively recently, perhaps as little as a decade ago, neither international pressures nor government deficits played a significant role in Japanese policy decisions. Japan was, in effect, a closed economy with a government that, for the most part, maintained a balanced budget. Thus, Japanese monetary policy was insulated from many of the forces that today weigh heaviest on critical decisions. A better understanding of how this environment influenced the development of the financial system will help to shed some light on upcoming changes.

Following the war, when the country was undergoing extraordinarily fast growth, Japanese businesses were unable to generate internally the funds necessary to finance such rapid expansion. In addition, the markets for direct business financing developed only slowly, for a number of reasons. The bond market was initially depressed by high postwar inflation. In subsequent years, however, it failed to mature primarily because of the government's practice of setting the yields for new issues of public and industrial bonds below market-clearing levels. At the outset, this low-interest-rate policy was adopted to promote capital investment, exports, and economic growth in general. It has been perpetuated, however, primarily to limit the cost of government debt financing. The reason why the stock market did not emerge as a major vehicle for business financing is less apparent. One possible explanation may be that the banks--acting as financial intermediaries--were simply more efficient in diversifying risk and in reducing transactions, information, and monitoring costs.

In any event, Japanese firms as a result relied heavily on the banks--that is, on indirect financing--for funds. Moreover, because of the underdevelopment of the bond and stock markets, most of Japan's high level of household savings was channeled into the banking system. Thus, until the mid 1970s, the banks' main function was to funnel the excess of savings in the personal sector to the corporate sector.

During this period, the Japanese banks were strongly dependent on the central bank, the Bank of Japan (BOJ), for funds to support the fantastic increase in credit called for by the postwar expansion. The city banks--those banks headquartered in the major metropolitan areas--provided the bulk of the financing for the country's major firms. These banks were particularly dependent on borrowings from the BOJ, because the demand for loans quickly outstripped the growth in their deposit base, and because of the way in which the BOJ conducted monetary policy in order to supply high-powered money to the banking system.

Conduct of monetary policy

For much of the period, the BOJ focused on the volume of city bank lending and the "call money" rate as its operating targets. (The call money market in Japan is similar to the federal funds market in the United States in which banks make short-term, often overnight, loans to one another. Through the call money rate, the BOJ can affect the volume of non-city-bank lending.) Although technically the operating tools of the central bank included changes in reserve requirements and open market operations, the primary tools used by the BOJ until the early 1970s involved changes in the conditions under which it would lend to the banks and direct controls over bank lending to firms.

Central bank discounts and loans were the main avenue through which the BOJ channeled high-powered money to the banking system. Generally, the monetary authorities set the discount rate below market-clearing levels. This created an excess demand for BOJ money and compelled the central bank to ration credit. The rationing system was formalized in November 1962, when individual loan ceilings were imposed on the ten city banks whose dependence on BOJ borrowings was especially high. The central bank set a penalty rate on borrowings in excess of the ceilings, but excessive borrowing was viewed as being out

of the question and never occurred. Even within the ceilings, borrowing from the BOJ was considered very much a privilege, not a right. Since the discount rate was below market-clearing levels, changes in the rate mainly operated through an "announcement effect," foreshadowing a change in the central bank's lending policy. Changes in the BOJ's lending ceilings affected the profit-maximizing level of bank loans both through a direct effect on bank liquidity and through an indirect cost effect, as city banks' borrowing in the higher-cost call-money market was affected.

In order to insure that the burden of adjustment to any tightening of monetary policy fell promptly and precisely on the volume of bank loans, the BOJ supplemented its lending policy with direct quantitative limits on banks' lending termed "window guidance." Window guidance was used only during periods of tight money, and at other times remained essentially in abeyance. Compliance with the window guidance ceilings generally was satisfactory, as the major banks relied heavily on cheap BOJ credit and feared that any violation would result in reduced access to it.

The central bank used changes in reserve requirements only infrequently in the early postwar period. The authorities sometimes raised the requirements, but did so primarily to increase the banks' dependence on the BOJ and enhance lending policy effectiveness.

For much of the period, open-market operations as they are conducted today in the United States were also not an important tool of monetary policy—principally because of the absence of a well-developed securities market, particularly for government securities. The government issued short-term bills to take care of seasonal deficits. However, since rates on the bills were fixed at relatively low levels, private holdings were negligible and they generally were purchased by the BOJ. Moreover, for a time long-term government bonds were not available for these operations, since the government pursued a balanced-budget policy through fiscal 1964. Even when the government began to issue long-term bonds to finance its deficits in fiscal 1965, the open market operations had some unique features.

As mentioned earlier, because of the BOJ's low-interest-rate policy, government bonds were issued at below-market yields and the government's Trust Fund Bureau and syndicates of financial institutions were compelled to underwrite them. Reluctantly, banks were willing to do so only because of their indebtedness to the BOJ and because government bonds could be used as collateral for BOJ loans. Open-market purchases by the BOJ were then allocated among specified banks in specified amounts. Thus, the operations, were, in effect, compulsory changes in the reserves of certain banks, with purchases just another form of central bank lending.

Because of the government's low interest-rate policy, interest rates, in general, were not allowed to perform fully their function of equating the quantity of funds demanded and supplied. Instead, the monetary authorities relied on credit rationing devices at various points in the system: indirect limits on corporate bond issuance (since terms for new issues were set below market-clearing levels), quotas for the conduct of open market operations, ceilings on each bank's discounts from the central bank, and direct limits on the quantity of each city bank's loans. The extent to which market forces were still at work has been widely debated. Nevertheless, the government's low interest-rate policy was, in fact, a major determinant of the structure of the postwar financial system.

Monetary policy effectiveness

Until the mid 1970s, the Japanese government relied on monetary policy as its primary policy tool. The effectiveness of changes in monetary policy was heightened by the heavy dependence of the banks—particularly the city banks—on the BOJ for loans and by the heavy dependence of firms on the banks for financing.

Perhaps equally important to the effectiveness of Japanese monetary policy, however, was the isolation of the economy from the rest of the world through strict foreign exchange (trade and capital) controls. Virtually all capital transactions were subject to government approval, including foreigners' acquisition of stocks, foreign borrowing by nonbank residents, and the transfer of capital and investment abroad. The authorities then eased or tightened restrictions as necessary to prevent undesired capital and reserve flows. These capital controls were particularly crucial in light of the government's desire to keep Japanese interest rates at low levels and in order to prevent Japanese companies from circumventing credit restraint by borrowing abroad.

If the domestic money supply is viewed as varying with changes in the banking system's holdings of net foreign assets and changes in credit to the private sector or to the government, then these exchange controls kept changes in the banking system's net foreign assets a relatively minor influence on changes in the domestic money supply at least until the late 1960s. Changes in net credit to the government were also insignificant, since budget deficits were either nonexistent or relatively minor during this period. Thus, even though the yen was held fixed against the dollar during the early postwar period, the BOJ was able to control the domestic money supply by directly regulating credit to the private sector through its monetary policy instruments.

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